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Unanswered Questions About Bear's Death

By Scott Patterson
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The drama that has gripped financial markets the past few days wouldn't be complete without a cliffhanger. The one consuming Wall Street these days is this: What killed Bear Stearns?

The investment bank's collapse might look easily explained: Its lenders fled as rumors swirled that Bear was running short on cash, an old-fashioned bank run.

But the rumors and the cash crunch lead to a chicken-and-egg conundrum: Which came first, the cash crunch, or rumors of the cash crunch? Were the rumors the result of the normal sort of panic that plagues Wall Street, or something more malicious?

Wall Street analysts, as usual, were caught off guard. Buckingham Research analysts argued in a March 11 report that concerns about Bear's access to cash were "overdone." Lehman Brothers reiterated its $110 price target for Bear on March 13, three days before Bear got sold for $2 a share to J.P. Morgan Chase.

Analysts aside, there were plenty of people in the market who saw something very bad coming. Securities regulators are looking at suspicious trades in stock-options contracts.

On March 10, traders purchased roughly 30,000 "put" options that would pay off if Bear's stock, then trading in the mid-$60s, fell to $35 by March 20, according to Universa Investments, a Santa Monica, Calif., hedge fund that specializes in exotic options-trading strategies. Another 20,000 or so put options that would pay off if Bear's stock fell to $25 by March 20 were purchased on March 13.

In effect, the contracts only hit the jackpot if Bear suffered an extreme event, quickly. "These were incredibly unusual orders," says Mark Spitznagel, Universa's manager.

Of course, there's another explanation in this mystery: Bear dug its own hole. Like all of the investment banks, Bear was heavily leveraged. Its assets were 33 times greater than its equity capital, meaning it depended heavily on borrowed money to invest.

It was about as leveraged as Carlyle Capital, the mortgage fund that was pushed to the brink last week. When you depend that heavily on debt, there's very little margin for error.

Reality Check: Profit Expectations Too High

Even if you think the credit market's and economy's problems have been totally solved, you might find the following predictions tough to swallow:

Financial-sector earnings will be up 315% in the fourth quarter of this year from last year and 27% for all of 2008.

Overall, companies in the Standard & Poor's 500-stock index will enjoy earnings growth of 74% year over year in the fourth quarter and 17% for 2008, the biggest gain since 2004.

Anyone with a toe in reality should be skeptical of such numbers, which are the forecasts among Wall Street analysts, according to data compiled by S&P.

Analysts have been downgrading their earnings expectations. But they're not done, especially if the economy is in recession. Earnings fell 31% in 2001, the year of the most recent recession, according to S&P. They fell 7% and 15%, respectively, in 1990 and 1991, the prior recession. They fell an estimated 6% in 2007, when the economy was apparently not in recession. It's hard to see how they'll rebound dramatically in a year that could include a recession.